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IN THE

Supreme Court of the United States

OCTOBER TERM, 1958

No. 236

STERN & STERN TEXTILES, INC. (Successor In Interest to HUGUET FABRICS CORPORATION), *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR WRIT OF CERTIORARI

To the United States Court of Appeals for the Second Circuit

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COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRIT OF CERTIORARI

To the United States Court of Appeals for the Second Circuit

Stern & Stern Textiles, Inc., a corporation organized and existing under the laws of the State of Delaware (hereinafter referred to as petitioner), successor in interest to Huguet Fabrics Corporation (hereinafter referred to as Huguet), petitions the Supreme Court of the United States to issue a writ of certiorari to the United States Court of Appeals for the Second Circuit to review its judgment entered in the above-entitled case on March 23, 1959.

OPINIONS BELOW

The opinion of The Tax Court of the United States (Appendix 10a) is reported in 26 T.C. 1000. The opinion of the United States Court of Appeals for the Second Circuit is reported in 263 F. (2d) 538 (Appendix 3a).

This case involves an issue of collateral estoppel which brings into play two prior Tax Court opinions written in a single case, one withdrawn, the other final, concerning a tax controversy between the same parties for a prior year. Such opinions are reported in 18 T.C. 605 and 19 T.C. 535, respectively.

JURISDICTION

The grounds on which the jurisdiction of this Court is invoked are the following:

The judgment of the Court of Appeals was entered on February 2, 1959. The order denying the petition for rehearing was entered on March 23, 1959.

On June 15, 1959, the time for filing a petition for a writ of certiorari was extended by order of this honorable Court to and including July 21, 1959.

The jurisdiction of the Supreme Court is invoked under Title 28 U.S.C. 1254 (1).

QUESTIONS PRESENTED

The questions presented are as follows:

I.

Is the doctrine of collateral estoppel applicable in a tax case for later years when the decision in the prior case turned on a mutual mistake of fact?

II

Can the rule of collateral estoppel be invoked in the tax matter of later years when the decision in the prior case turned on the insufficiency of proof, and where the holding of insufficiency of proof was based upon an erroneous and incomplete joint stipulation of facts in the prior case?

III

Can the plea of collateral estoppel be availed of when the facts to be heard in the present case differ materially from those heard in the prior case?

IV

Can the respondent, to the detriment of the petitioner, take advantage of a mistake to which he was a party?

V

Can the plea of collateral estoppel be availed of when there has been a change of legal climate between the prior decision and the present case?

VI

Could the Tax Court, acting under an Order

> "that the Court hear and determine first and apart from the other issues in these proceedings whether the doctrine of *res judicata* and/or collateral estoppel bars the petitioner as a matter of law from a hearing on the merits"

review and decide the present case on its merits, and conclude that the judge in the prior case would have reached the same decision from the actual facts that

he reached from an erroneous stipulation by both parties?

VII

Could the Tax Court decide a tax case arising under Section 722 of the Internal Revenue Code of 1939, as amended, without a review by "a special division of the Tax Court which shall be constituted by the presiding judge and consist of not less than three judges of the Tax Court" (Section 732 (d), Internal Revenue Code)?

VIII

Could the Tax Court, sitting as an administrative agency under a special section of the Internal Revenue Code providing a particular form of relief, which allowed no appeal from the Tax Court's decision, apply the rule of collateral estoppel and thus prevent a hearing on other causes of action for later years?

IX

Could the Circuit Court on review apply the rule of collateral estoppel after it had recognized an error in the prior case which it said "may well have" caused the Tax Court to make the erroneous finding of fact?

STATUTES AND REGULATIONS INVOLVED

The statutory provisions and regulations involved are:

(1) Title 26, U. S. Code, 1952 ed., Chapter 2, Subchapter E, Section 722 and Section 732.

(2) Internal Revenue Regulations 112.

Relevant parts of the statutes and regulations involved are printed in the Appendix beginning at page 18a of this petition.

STATEMENT OF THE CASE

The petitioner is the successor in interest of Huguet Fabrics Corporation, and the case here under review is the excess profits tax case of Huguet Fabrics Corporation (hereinafter called Huguet).

Huguet duly filed its tax returns for its successive fiscal years ended September 30, 1941, 1942, 1943, 1944, 1945, and 1946, and duly paid the amounts shown thereon to be due. These taxes included various amounts of excess profits taxes.

In computing excess profits taxes, Huguet's average base period net income, without any reconstruction under Section 722 of the Internal Revenue Code, was $20,792.93, (19 T.C. 535, at page 539), and such amount was used as the basis for calculating the excess profits taxes paid.

For each of its taxable years involved, and in due time, Huguet filed claims for relief under Section 722 of the Internal Revenue Code of 1939, as amended (Appendix 18a), claiming that its excess profits tax credit without relief under Section 722 was far too low. In filing its claims, Huguet claimed under all the provisions of Section 722.

Petitioner's claim for refund for excess profits taxes for the fiscal year ended September 30, 1941, was denied by the Commissioner of Internal Revenue. In due time, as allowed by the Internal Revenue Code (Section 732 (a)), the petitioner filed a petition with the Tax Court seeking a refund under the provisions of Section 722.

This case came on to be heard in the Tax Court on October 23-24, 1950.

In the Tax Court, the petitioner abandoned its claims to relief under subsections (b) (1), (2) and (3), of Section 722 and decided to and did rest its case on Section 722 (b) (4) (19 T.C. 535, at page 541). Section 722 (b) (4) (Appendix 20a) provides for a constructive base period net income to be used in computing excess profits taxes, and for a two-year push-back, in those instances where the character of the business was changed during the base period (1936 to 1939 for calendar year taxpayers, or in this instance, the fiscal years October 1, 1936, to September 30, 1940).

Section 722 (b) (4) and the regulations thereunder (Appendix 23a, *et seq.*) provide that either a change in a taxpayer's product or a change in the method of distribution of a taxpayer's product was such a change in the character of the business as would qualify the claimant for a constructive base period net income.

At the Tax Court hearing in October 1950 on the 1941 case, the petitioner showed that it had formerly made delicate sheer silk materials for ladies' outer garments and expensive evening dresses, and that it had enjoyed considerable prosperity in that field, but that due to changing styles, the inroads of rayon and a growing unpopularity of silk, petitioner had had to seek a new product in order to survive.

Petitioner showed that, during its base period, it employed expert help and conducted numerous experiments in the search for a new or more profitable product, and a new and more profitable method of operating. Towards the end of its base period, petitioner set out on a program to change the major part of its production to strong utility fabrics (made of the newly invented thread known as nylon), for women's under-

garments such as brassieres and girdles, and began to distribute and sell such nylon fabrics, not through jobbers as it had always sold its silk products, but directly to the manufacturers of such sturdy undergarments.

This was a new and different product and a new and different method of distribution.

At the trial table, the parties stipulated that if the point of law was decided in favor of the petitioner, the Tax Court should use as the basis of a reconstructed average base period net income one dollar a pound profit for each pound of nylon thread constructively used by petitioner. The testimony was that the poundage would be 20,000 pounds a month, or 240,000 pounds a year, making a constructive profit of $240,000 a year, subject to a formula used in such cases and known as the "Index, Commissioner's Mimeograph 5807, Series B."

The parties also filed a joint stipulation which the respondent, in good faith, had requested the petitioner to sign, and which the respondent and the petitioner both thought to be true.

Among the exhibits to this stipulation was Exhibit 6-F (Appendix 29a). Exhibit 6-F was an incomplete columnar statement which showed "Sales" for the year ended September 30, 1940 (the last year of the petitioner's base period), in the first column as $1,047,381.93; and which listed in five columns sales totalling $940,532.51 to five of the customers of the petitioner, all five of whom were jobbers and old customers of the petitioner. Sales of $106,849.42 to others were not listed or accounted for.

The Tax Court, in its first opinion (18 T.C. 605, at page 613), recognized that the petitioner had changed its business by going into the manufacture of fabrics made of nylon instead of silk, but held that the change from silk to nylon was not such a change as would qualify the petitioner to receive the benefits of Section 722 (b) (4).

The Tax Court, in its first opinion also recognized that petitioner had shown by the testimony of its general manager that the petitioner had established a new and different method of distributing its products, namely, by selling its products direct to manufacturers, rather than through jobbers, but ruled that this evidence was set at naught by Exhibit 6-F of the stipulation, which showed sales to jobbers only. The Tax Court, not realizing that the listed sales to jobbers on Exhibit 6-F was not an itemized list of *all* sales, reasoned that no sales could have been made to manufacturers if all sales were made to jobbers. The Tax Court had not noticed the difference of $106,849.42, and erroneously assumed that the sales listed to the five jobbers, if added, would reach the total sales of $1,047,381.93.

The Tax Court considered Exhibit 6-F controlling, and on the conclusion it reached from Exhibit 6-F, ruled against the petitioner, saying:

> "* * * While these stipulated facts are in conflict with the testimony of petitioner's general manager, who testified that all of petitioner's sales of nylon fabrics for the fiscal year ended September 30, 1940, were made directly to manufacturers of undergarments, the facts stipulated must prevail." (18 T.C. 605, at page 612.)

The petitioner filed with the Tax Court a timely request for a rehearing, pointing out the error made by the Tax Court in considering the stipulation. Upon considering the request for a rehearing the Tax Court realized the error it had made in misreading the stipulation and reopened the case, but without a hearing.

The Tax Court then again decided the matter against the petitioner, and again reached its decision on the basis of that same stipulation, Exhibit 6-F, pointing out that:

> "* * * While it may be possible (as the manner in which the stipulation was presented certainly tends to indicate) that the stipulation was intended to show that all sales were made to the five jobbers and that the difference between the total of these sales and the total sales listed for each month may be the result of not including in the total figures any sales adjustments, such as sales returns and allowances, *it is probably more nearly correct that the difference is in fact due to sales to other customers*, as petitioner's attorney contends. Accordingly, looking at the total sales of the five jobbers in September 1940, we find there exists between this amount ($81,719.84) and the total sales ($90,939.50) a difference of $9,219.66. However, the stipulation [Exhibit 7-G] shows that during this month there were nylon sales of $10,346.45, which by basic arithmetic would mean that $1,126.79 worth of such sales would necessarily have been made to the five named jobbers, none of whom were manufacturers of undergarments." (19 T.C. 535, at page 545.) (Italics added.)

In both its first opinion and its second opinion, the Tax Court turned the case squarely on Exhibit 6-F, and so stated:

> "The state of the record with respect to *this important* element of the alleged change is indeed

confused, and the petitioner has not met its burden of proving that during the base period it embarked upon a new and different business.

* * *

"We must conclude from the state of the record in this case that insufficient evidence was introduced to establish the existence during the base period of a qualifying change within the requirements of Section 722 of the Code." (19 T.C. 535, at pages 546, 547.) (Italics added.)

After the decision in the 1941 case had become final, and after the petitioner's claims for relief under Section 722 for subsequent years had been denied and petitioner had filed petitions with the Tax Court seeking refunds for such later years, and after those cases for later years had been set for trial before the Tax Court, the respondent, on October 19, 1953, interposed a plea of collateral estoppel. This plea was grounded on the proposition that the decision in the prior case for 1941 estopped the petitioner for all time from having its claims for a constructive average base period net income and for relief under Section 722 of the Internal Revenue Code heard and determined.

Upon respondent's motion to sever the issues and to try the sole question of collateral estoppel first, the Tax Court issued an Order (Appendix 35a) setting the case for a hearing on the sole question of collateral estoppel.

On January 9, 1956, a hearing was had before the Tax Court under this Order.

At the hearing, the petitioner proved that there was an error of $8,579.25 in Exhibit 6-F, the exhibit on

which the Tax Court had turned its decision in the prior case.

It was shown that, whereas the stipulation, Exhibit 6-F, showed, for the month of September 1940, total sales of $90,939.50 and itemized sales of $81,719.84, the correct figures were total sales of $90,939.50 and itemized sales of $73,140.59, a difference in itemized sales of $8,579.25.

The error was in the column of sales to Wm. Cohen Fabrics. Sales to Wm. Cohen Fabrics in September 1940 were listed on Exhibit 6-F as $8,579.25, whereas no sales whatever were made to Wm. Cohen Fabrics in September 1940 (R. 35*). No sales had been made to Wm. Cohen Fabrics since May 1940 (R. 35).

When this error is corrected, the reasoning on which the Tax Court turned the prior case would fall.

The Tax Court, in the prior case, did not know of this error, which was not discovered until the decision in the prior case had become final. The Tax Court had found for September 1940 sales of $90,939.50, itemized to the extent of $81,719.84 as sales to jobbers, plus nylon sales of $10,346.45, making a total of $92,066.29,

> "which by basic arithmetic would mean that $1,126.79 worth of such sales would necessarily have been made to the five named jobbers, none of whom were manufacturers." (19 T.C. 535, at page 546.)

On the corrected figures, there would be sales of $90,939.50, itemized to the extent of $73,140.59 as sales to jobbers, plus nylon sales of $10,346.45, making a

* Record references are to certified transcript of record and proceedings in the United States Court of Appeals for the Second Circuit, Vol. I.

total of $83,487.04*, "which by basic arithmetic" would mean that *none* of such sales would have been made to the five named jobbers. Another $7,452.46 of sales for the month of September 1940 would have to be accounted for as sales to other purchasers before there would be such an overlap as would "by basic arithmetic" suggest that any nylon sales were made to jobbers.

The petitioner also proved by its books of account that it made nylon sales in the year ended September 30, 1940, of $16,458.01, and showed to whom such sales were made** (R. 32

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* Correcting the stipulation, Exhibit 6-F, the month of September 1940 shows:

Sales		$90,939.50
Stern & Stern	$43,898.17	
Goldenbro Fabrics	28,118.91	
Kimball, Inc.	500.72	
Mann & Delaney	622.79	
Wm. Cohen	0	
Total Sales Accounted for	$73,140.59	
Add nylon	10,346.45	
Total Sales to Five Named Jobbers plus Total Sales of Nyon		$83,487.04
This leaves:		
Sales not made to any of the Five Named Jobbers		$ 7,452.46

** Fay Miss Brassiere Co. named later changed to Bali Brassiere Co. $15,979.68
Endurette Corp. of America 24.65
Warner Brothers 51.57
Julius Kayser & Co. 354.94
National Ass'n of Dyers & Cleaners 14.97
Stern & Stern Textile Importers, Inc. 1.40
E. I. duPont deNemours Co. 30.80
$16,458.01

The parties stipulated at the hearing (Appendix 30a) that the sales were made to:

(1) Fay Miss, later known as Bali Brassiere Co.; Julius Kayser & Co., Endurette Corporation of America, and Warner Brothers, all of whom were manufacturers; and

(2) As samples not for resale, to E. I. duPont de Nemours, National Association of Dyers and Cleaners, Stern & Stern Textiles, Inc. These latter sales were in a total amount of only $47.17.

After hearing this case under the Order confining the matter to the sole question of collateral estoppel, and without having allowed the petitioner to be heard on the merits, the Tax Court, acting through one judge, and without a review by "a special division of the Tax Court which shall be constituted by the presiding judge and consist of not less than three judges of the Tax Court," as required by law,* considered this case on the merits, and despite the order to hear only the collateral estoppel question, decided the case on the merits, stating:

> "ORDERED and DECIDED: That the petitioner is not entitled to relief for the year ended September 30, 1942 [1943, 1944, 1945, and 1946], under the provisions of Section 722, Internal Revenue Code." (Appendix 9a:)

The petitioner appealed to the United States Court of Appeals for the Second Circuit, under the provisions of Sections 7482 and 7483 of the Internal Revenue Code of 1954, and Section 732(c) of the Internal Revenue Code of 1939. The Second Circuit affirmed the decision of the Tax Court.

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*Section 732 (d), Internal Revenue Code (Appendix 22a).

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT OF CERTIORARI

Summary

I. The decision below is contrary to the decisions of this Court.

(a) Mutual mistake of fact

(b) Change of legal climate.

II. There is a conflict between the Circuits on the question of collateral estoppel in tax cases.

III. The Tax Court, under the special statute authorizing it to review refund claims for relief under Section 722 of the Internal Revenue Code, was required to have its decisions reviewed by a special division of its members consisting of three or more of its judges appointed by its presiding judge. In this case no such review was had, and a motion seeking such a review was summarily denied.

IV. The Tax Court, under the special statute authorizing it to review refund claims for relief under Section 722 of the Internal Revenue Code, did not have authority to apply the rule of collateral estoppel. Its sole authority was to hear the claims, have them reviewed by a special committee of its judges, appointed by its presiding judge, and dispose of them.

V. The respondent is basing a plea of collateral estoppel upon his own mistake and ought not to be allowed to do so.

VI. The Second Circuit departed from the issues before it in sustaining the Tax Court.

I. THE DECISION BELOW IS CONTRARY TO THE DECISIONS OF THIS COURT

(a) Mutual Mistake of Fact

This is a tax case in which the Courts below have applied the rule of collateral estoppel. The prior case, which is the basis for the plea of collateral estoppel, involved another and different taxable year from those involved in the present case. In that prior case, there was a mutual mistake of fact on which that prior case turned. Now the petitioner has been held to be estopped to try its present case and to present the true facts. The question really is this:

> Must a mutual mistake of fact in a tax case for one year go on and on year after year uncorrected, to the great detriment of the petitioner, or can the mistake be corrected and the true facts presented in the tax cases for later years?

It is respectfully submitted that the question presented by this case was answered by the *Sunnen* case (*Commissioner* v. *Sunnen*, 333 U.S. 591, 68 S. Ct. 715), in the petitioner's favor.

The case at issue presents the very situation which was before this honorable Court in the *Sunnen* case, and in that case this Court required that:

> "collateral estoppel be used with its limitations carefully in mind so as to avoid injustice." (*Commissioner* v. *Sunnen*, supra.)

Every word of the *Sunnen* case applies with peculiar force to the case at bar:

> "(7) But collateral estoppel is a doctrine capable of being applied so as to avoid an undue disparity in the impact of income tax liability. A

taxpayer may secure a judicial determination of a particular tax matter, a matter which may recur without substantial variation for some years thereafter. But a subsequent modification of the significant facts or a change or development in the controlling legal principles may make that determination obsolete or erroneous, at least for future purposes. If such a determination is then perpetuated each succeeding year as to the taxpayer involved in the original litigation, he is accorded a tax treatment different from that given to other taxpayers of the same class. As a result, there are inequalities in the administration of the revenue laws, discriminatory distinctions in tax liability, and a fertile basis for litigious confusion. Compare United States v. Stone & Downer Co., 274 U.S. 225, 235, 236, 47 S. Ct. 616, 71 L. Ed. 1013. Such consequences, however, are neither necessitated nor justified by the principle of collateral estoppel. That principle is designed to prevent repetitious lawsuits over matters which have once been decided and which have remained substantially static, factually and legally. It is not meant to create vested rights in decisions that have become obsolete or erroneous with time, thereby causing inequities among taxpayers."

Just as in the *Sunnen* case, the present case involves different taxable years than that involved in the prior case upon which the plea of collateral estoppel was based.

In the present case, there has been more than a "modification of the significant facts", there has been proof of a mutual mistake of fact in the prior case.

In the case at issue, the mutual mistake has been shown. The Tax Court in the prior case, before the mistake was discovered, in two opinions turned the

prior case on the effect of the joint stipulation which later proved to have been erroneous.

The Tax Court in the case now at issue here presumed to say that the Tax Court in the prior case would have reached the same conclusion on a correct stipulation that it reached on the false and misleading stipulation. But who can say as to that? The question is "for the jury," and the "jury" in the prior case was one judge and a committee of three or more reviewing judges appointed by the presiding judge of the Tax Court. Only a trial in the present case can solve this important question. (See Section II.)

Coming now to the decision of the Second Circuit in the case here at issue, we find that Court saying that if the mistake was material, it would hold for the petitioner. Said the Second Circuit:

> "* * * Indeed, if the error was of such a character that the substitution of an accurate statement of the facts would require a finding in this case that 'the taxpayer either during or immediately prior to the base period, commenced business or changed the character of the business and the average base period net income does not reflect the normal operation for the entire base period' (Section 722 [b]), we would favor a reversal of the decision of the Tax Court." (Appendix 7a.)

After saying that, the Second Circuit recognized the materiality of the mistake, for it said:

> "* * * *Because of this error*, the court may well have found that instead of selling its nylon products directly to manufacturers as claimed, taxpayer still used jobbers during the crucial period." (Appendix 8a.) (Italics added.)

After finding that there was a mutual mistake of fact in the prior case, and after recognizing that it was material, the Second Circuit should have held for the petitioner. Instead of holding for the petitioner, the Second Circuit digressed into other matters not before it for review, and indeed even into the merits of the prior case, and decided that petitioner was collaterally estopped to try its case. (The Second Circuit's digression is discussed below herein, at Section VI.)

Petitioner believes that the present case falls within that area in which this honorable Court has said that the doctrine of collateral estoppel is to be used only "with its limitations carefully in mind so as to avoid injustice."

If the present case does not fall within that area outlined in the *Sunnen* case, then it is a matter of national importance that this honorable Court should undertake to clarify and define the law regarding collateral estoppel in tax cases involving mutual mistake of fact.

(b) Change in Legal Climate

It is respectfully urged that there has been a complete change in the legal climate in the area of Section 722 relief since the decision of the prior case in the winter of 1952.

In this case there was an admitted change in this company's product from silk to nylon. Upon a two-year push-back rule, that change would have been a very great change indeed. It would certainly have been so extensive a change and so complete a change as to qualify this petitioner under Section 722 (b) (4)

if the character of the change itself was a qualifying change under Section 722 (b) (4).

In the prior case, the Tax Court ruled that a change from silk to nylon was not such a change as would qualify the petitioner under Section 722 (b) (4). Said the Tax Court:

> "We have found as a fact that the petitioner commenced the manufacture and sale of fabrics manufactured from nylon in the last quarter of its fiscal period ended September 30, 1940. This was, of course, a change; however, not every change is sufficient to satisfy the requirements of the statute. * * * " (19 T. C. 535, at page 542.)

Since the decision in the prior case, however, the climate has changed, and the Tax Court now recognizes that a change from silk to nylon—standing alone—is a "revolutionary change," and that that change alone and of itself, is a qualifying factor under Section 722 (b) (4). Said the Tax Court in *Davenport Hosiery Mills, Inc.*, 28 T. C. 201 (April 30, 1957):

> "* * * We think the facts show that the change to nylon was not only substantial but was revolutionary. * * * " (28 T. C. 201, at page 215.)

The change from silk to nylon under the prior decision in petitioner's case in December 1952 was held to be no change at all. The change from silk to nylon was a "revolutionary change" in April 1957, and it is submitted that this petitioner in 1959 is entitled to enjoy the more temperate climate.

Surely each separate Section 722 tax case before the Tax Court is not settled whimsically regardless of fact and law, favoring some and punishing others.

It is far more likely that the Tax Court with the passing of time has come to realize that manufacturing nylon is indeed a great change from manufacturing silks.

Surely if, under the present climate, a change from manufacturing silk stockings to manufacturing nylon stockings is a revolutionary change qualifying under Section 722 (b) (4) (*Davenport Hosiery Mills, Inc., supra*), a change from manufacturing silk sheers for fine evening gowns to manufacturing plain strong nylon goods for brassieres and girdles is an even more complete change.

II. THERE IS A CONFLICT BETWEEN THE CIRCUITS IN THE MATTER INVOLVED

In the case of *Parker* v. *Westover*, 221 F. (2d) 603, in the United States Court of Appeals for the Ninth Circuit, a tax deficiency was assessed against the parents in an alleged family partnership (parents and minor children) case. The parents paid the tax and sued the Collector to recover. The Collector won.

Subsequently, the parents entered into an agreement with the State court concerning the handling of the alleged partnership's funds in connection with tax litigation.

Thereafter, tax deficiencies for later years were assessed against and collected from the parents. The parents again sued to recover.

The Collector pleaded collateral estoppel.

On the thin thread of the State Court proceedings concerning the finances of the partnership, the rule of collateral estoppel was held not to apply.

The Ninth Circuit, in the *Parker* case, said:

> "* * * The possibility of a different verdict because of the introduction of evidentiary facts different from those before a court and jury in a prior case is sufficient to surmount the danger of collateral estoppel in an income tax situation. The new evidence need not positively change the character of the case. It need only change the complexion of the significant facts presented to the jury. The settlement of an evidentiary fact question, once in dispute before a jury, which has a significant bearing on the case, lifts the bar of collateral estoppel. In a new trial, both the taxpayer and the Government will be in a position to argue to a jury the effect of this new evidentiary fact upon the original partnership agreement."

In a Section 722 Tax Court case, the "jury" might be said to consist of the trial judge, or judges, and a committee of three or more judges of the Tax Court, appointed by the presiding judge.

Once a mistake of fact had been found in the case at bar, the Second Circuit should have reversed the Tax Court and remanded the case to the "Tax Court-jury".

Since the Ninth Circuit takes one view of collateral estoppel in tax cases, and the Second Circuit takes another view, it is important that this honorable Court should resolve the conflict between the circuits by granting a writ of certiorari here.

III. THE TAX COURT, UNDER THE SPECIAL STATUTE AUTHORIZING IT TO REVIEW REFUND CLAIMS FOR RELIEF UNDER SECTION 722 OF THE INTERNAL REVENUE CODE, WAS REQUIRED TO HAVE ITS DECISION REVIEWED BY A SPECIAL DIVISION OF ITS MEMBERS CONSISTING OF THREE OR MORE OF ITS JUDGES APPOINTED BY ITS PRESIDING JUDGE. IN THIS CASE NO SUCH REVIEW WAS HAD, AND A MOTION SEEKING SUCH A REVIEW WAS SUMMARILY DENIED

The final determination of tax refunds arising out of claims for relief under Section 722 of the Internal Revenue Code was entrusted to the Tax Court of the United States absolutely, and without a review (Section 732 (c) and (d), Appendix 21a-22a).

Before the enactment of Section 732, the Tax Court had no jurisdiction over refund cases. Its authority to hear refund cases under Section 722 rests solely on Section 732 of the Internal Revenue Code (Appendix 21a-22a).

In order to protect the taxpayer's rights against capricious, whimsical or prejudicial action by any one judge of that Court, the statute wisely and specifically provided and required that no one judge of that Court could determine the rights of any taxpayer under Section 722. It provided that a special committee consisting of not less than three judges of the Tax Court should be appointed by the presiding judge to review all decisions on *any* question whatsoever arising under Section 722.

In the case here at bar, the decision that this petitioner was not entitled to relief under Section 722 was made by one and only one judge of the Tax Court, and a review by a special committee of not less than three judges was not afforded.

The petitioner duly filed a motion asking for such a review (Appendix 31a), and it was summarily denied.

It is respectfully submitted that where an administrative body is designated by statute to do a certain thing in a specified way, it must conform to the mandate of the statute creating its power and designating its duties. The Tax Court, in acting through a single judge and in purporting to decide this claim for a great amount of money against this petitioner without following the statute under which it was empowered to hear this claim, exceeded its authority and took property from this petitioner without due process of law.

The petitioner, in appealing to the Tax Court for its refund, was assured by Congress a degree of fair play and a serious consideration of its rights that it could not expect from one lone judge and that it did not get. Congress promised the petitioner that its claim would not only be heard, but that the decision in its case would be reviewed by a committee of not less than three judges selected by the presiding judge of the Tax Court. This promise was not kept. The action of the one judge of the Tax Court who decided this case on its merits without a hearing on its merits was not reviewed by a committee of three judges appointed by the presiding judge of the Tax Court, nor was it reviewed at all. The petitioner was entitled to such a review as a matter of law.

Congress well knew the dangers in delegating to administrative bodies the powers of the courts, and wisely made the provisions it did in Section 732 to prevent one single administrator from handling such important matters alone, without review. The provision for a review was necessary not only to insure some measure of justice, but to protect the Federal revenues. The review was mandatory.

It is respectfully submitted that when Congress went so far as to entrust the final decisions in such important

matters concerning the Federal revenue to an administrative body, without the right of an appeal to any court, instead of to a court, it expected the administrative body, at the least, to go through the form of having the review which Congress instructed it to afford.

It is submitted that the failure to afford the prescribed review was a fatal error and for this reason, if for no other reason, this case should be remanded.

IV. THE TAX COURT, UNDER THE SPECIAL STATUTE AUTHORIZING IT TO REVIEW REFUND CLAIMS UNDER SECTION 722 OF THE INTERNAL REVENUE CODE, DID NOT HAVE AUTHORITY TO APPLY THE RULE OF COLLATERAL ESTOPPEL

It is respectfully urged that the Tax Court of the United States is a Federal administrative body having no rights or powers beyond those given to it by statute. The statute creating the Tax Court (then called the Board of Tax Appeals) designated it "an independent agency in the executive branch of the government" (53 Stats. 158, 26 U.S.C.A. § 1100), and it was so held by this honorable Court in *Old Colony Trust Co.* v. *Commissioner*, 279 U. S. 716, 49 S. Ct. 499.

The authority of the Tax Court was extended to cover claims for refund under Section 722 of the Internal Revenue Code by a special statute (Section 732, Appendix 21a) which set out the rights and duties of the Tax Court in such cases, and made its decisions final.

In the present case, instead of hearing petitions on the claims now before this Court as required by law, the Tax Court refused to hear them, and acting under its own Order to confine a hearing on the petitions to the sole question of collateral estoppel, decided the case purportedly on the merits, without ever having heard the merits. (The very manner of the decision was in

violation of the express provisions of the statute. That question is discussed above in Section III.)

It is respectfully urged that an administrative body, such as the Tax Court of the United States, when given certain jurisdiction by statute to hear and decide certain claims under a specified procedure which, if followed, allowed no appeal from its decisions, is required to hear such claims if properly presented to it, and to follow the indicated procedure.

In such cases there is no reason for a plea of collateral estoppel, for no question of repose is involved—a quick hearing, an immediate decision, and all is over. If the same facts are offered as were offered in a prior case, the Tax Court can make quick work of them, and no appeal will lie. If different facts or different legal principles or change in legal climate are shown in the new case, the new case must be decided on its merits, and no appeal is allowed. In either event, a few hours would dispose of the matter, once and for all.

Not only is there no need for the plea of collateral estoppel but that remedy of the law Courts is not and should not be available to administrative bodies. Administrative bodies have but to do what the statute directed them to do, and the matter is done with, once and for all.

The present case would have been finished, one way or another, about five years ago if the Tax Court had only done as the statute instructed it to do.

The Tax Court itself (then the Board of Tax Appeals), in a well considered opinion outlined its own measure of its powers in a situation comparable to the one here presented. In *Appeal of Union Metal Manufacturing Co.*, 4 B.T.A. 287, at page 288, it said:

"The argument as to the force of the doctrine of *res judicata* is deserving of the most careful consideration. It is an ancient doctrine and has been applied to judicial proceedings with unquestionably salutary effect. That it is a wise rule in many cases cannot be questioned. But it is in its nature a doctrine of expediency, devised in the belief that the public interest was better served by prohibiting repetitious litigation and assuming the correctness of a decision once rendered than by persisting in the search for truth and accuracy in each case. It has no absolute sanction in all circumstances and, if it does not fit the system in which it is invoked, its limitations may not be ignored.

"This Board is a new creature with a special place in the governmental system of settling disputes. With a function in all respects judicial as to such matters as come within the confines of its powers, it is, nevertheless, nominally outside the judicial system. This was especially so under the Revenue Act of 1924, in effect when this hearing was had. Designated by statute as a 'board' and as 'an independent agency in the executive branch of the government' with a duty to 'hear and determine appeals,' through a membership appointed 'solely on the grounds of fitness to perform the duties of the office,' it appeared to be the final arbiter of all appeals within its limited jurisdiction, for there was no review provided of its determinations. All its cases involved disputes between the taxpayer and the government as to income, profits, estate, and the moribund giff tax. The government was always a defendant. The questions were closely related and an error either in fact or law as to one taxpayer, or as to one year of tax, could affect the tax liability of many others so that it might project itself in an ever-growing circle to bring about great injustice and distort the public revenue. Thus

uniformity of precept, which has always been regarded as a desirable achievement, could become an instrument of destruction of justice and defeat its own principal purpose. If the perpetuation of error with such possible results can be avoided without at the same time involving the system in confusion and inefficiency, no adherence to a doctrine should be permitted to prevent its avoidance. And certainly this must be so at least until it is clearly demonstrated by experience of this special tribunal that the doctrine is indispensible. Its necessity should not be assumed while the Board is still at the threshold of its career.

"* * * While it is most expedient that there should be but one trial before the Board on a single issue and that the parties should abide the judgment in each case, this can not support a system which would make possible the projection of errors into other proceedings."

V. THE RESPONDENT IS BASING A PLEA OF COLLATERAL ESTOPPEL ON HIS OWN MISTAKE AND OUGHT NOT TO BE ALLOWED TO DO SO

The prior case turned upon a mutual mistake of fact in a stipulation.

The incorrect stipulation was asked for by the respondent, was agreed to by the petitioner, and was offered as a joint stipulation of both parties. Both parties thought the facts were correct.

The respondent now relies, as a grounds for collateral estoppel, on a mistake to which he was a party.

The foregoing temperate suggestion in no way reflects the petitioner's feeling in this matter. It is submitted that the United States (and any of its agencies and servants) when it comes into court should come in like a man, carrying the rights and duties of a man.

The rule that one should not take advantage of his own wrong, the rule that one who seeks equity shall do equity, and the rule that one must come into equity with clean hands all apply to the United States (and its servants and agents), once it is in court.

It seems to the petitioner that this situation applies with added force in tax cases where the belaboured taxpayer finds himself at such a great disadvantage in having always to carry the burden of proof. It should apply with even greater force in a Section 722 tax case where Congress admonished the taxing authorities to conduct an intelligent and sympathetic administration. (H. Report No. 146, 77th Congress, 1st Session, 1941 C. B. 550-551)

Surely the United States ought to be above collecting taxes that are not owed it, or keeping tax money that belongs to taxpayers, through the ignoble device of taking advantage of mistakes it induced and helped to make.

Indeed, the United States should be above taking advantage of a mistake no matter who made the mistake.

VI. THE SECOND CIRCUIT DEPARTED FROM THE ISSUES BEFORE IT IN SUSTAINING THE TAX COURT

After stating that it would hold for the petitioner if the mistake was material, and then recognizing the materiality of the mistake (which matters have been fully discussed by petitioner in Section I of this petition), the Second Circuit, instead of deciding for the petitioner, reviewed the prior case and concluded:

> "* * * the change in selling method was only one of several alternate grounds for the conclusion that base period net income had not been shown to be 'abnormal.'" (Appendix 8a.)

While the Second Circuit did not name the "alternate grounds" for finding that petitioner had not proved its base period net income abnormal, the Second Circuit did list four paraphrased points which it appears to have selected from the Tax Court opinion in the prior case and which it apparently considered important. These were:

> "(1) there was insufficient proof to show a change in the character of taxpayer's business either in the products manufactured or in the method of sales;
>
> "(2) there was insufficient proof that the asserted change resulted in lower costs;
>
> "(3) there was insufficient proof that any such alleged lower costs were not passed on to the taxpayer's customers; and
>
> "(4) the evidence did not indicate any temporary circumstances which depressed business during the base period." (Appendix 8a.)

With regard to the Second Circuit's first point above, petitioner is unable to find any foundation for the Second Circuit's conclusion that "there was insufficient proof to show a change in the character of taxpayer's business * * * in the products manufactured." The Tax Court said at page 542 of its opinion in the prior case (19 T. C. 535) that it *did* find a change in petitioner's product, but dismissed it as not being sufficient to satisfy the requirements of the statute. Petitioner has discussd this question under Section I (b), Change in Legal Climate, above, for the Tax Court found that such change *was* sufficient in the case *Davenport Hosiery Mills, Inc., supra.*

As to the other insufficiency of proof mentioned by the Second Circuit in its first point, proof of change

in the method of sales: the "insufficiency" would be cured on a trial of the present case, for it was this insufficiency which the Tax Court found resulted from the confusion growing out of the mutual mistake of fact in the stipulation. This question has been discussed by petitioner in Section I (a), Mutual Mistake of Fact, the principal question before the Second Circuit.

That leaves the last three points which might be described as "alternate grounds."

Point (2), namely "reduced costs": A showing of reduced costs is not a necessary element in a Section 722 (b) (4) case. In a Section 722 (b) (4) case the basic element is not *cost*. The basic elements are *change*, and then *profits*. Proof of reduced costs, however, and of increased profits was offered at the hearing and was not contradicted. The parties stipulated in the prior case that the *profit* in the changed business would be one-dollar a pound. (This is discussed below.)

Point (3) above, namely the "passing on of alleged reduced costs to customers"; Since costs are not a ruling factor, it is assumed that the Second Circuit meant "profits." There is no presumption of law that a company that seeks new outlets and new products in order to make a profit will give those profits away to the customers. If there is any presumption of law in such a case, it is that a person who makes a profit will endeavor to keep it. There is no rule or regulation under the tax law that requires proof of "no passing on" in order to qualify under Section 722 (b) (4). The idea of "passing on" was, in fact, an invention of the Tax Court in this case. Petitioner has been unable to find any reference to such a requirement of proof by the Tax Court in any other Section 722 (b) (4) case.

The facts are that the parties (petitioner and respondent together) at the trial table disposed of this whole matter by stipulating that the Tax Court should use, in making its reconstruction calculation of the changed business, the figure of one dollar a pound profit.

It is submitted that the Tax Court was bound by this stipulation, and under this stipulation no reduced selling price could reduce the petitioner's profit below one dollar a pound, nor could any lower or higher costs change that figure.

The Tax Court did not like that stipulation so it read it out of the record by the following remarkable statement found in its second opinion in the prior case:

> "* * * In this respect what the parties may have stipulated concerning reconstruction is neither competent nor sufficient to establish such facts." (19 T.C. 535, at page 547.)

But, fortunately, the matter was fully covered in the trial of the prior case, although the Tax Court closed its eyes to that fact, and misled the Second Circuit into doing the same thing.

The record in the trial of the prior case shows that the petitioner's general manager, who was a trained accountant, testified to the reconstruction of the net income of the petitioner's business under the two-year push-back rule laid down in Section 722 (b) (4). He started with a computation of receipts from sales, and went on to net profit. He showed a reconstructed basis of nylon consumed at 20,000 pounds a month, and arrived at a constructive net profit to the petitioner of

$286,406.04 per year. (Tr. 52-58, Hearing of October 23, 1950)

The respondent also put on an expert witness to show his reconstruction of petitioner's profit. After this testimony, the respondent and the petitioner read into the record an agreement (Appendix 30a) that the Tax Court should use the basis of one dollar a pound of nylon yarn constructively consumed as representing the profit of the petitioner to be used in the reconstruction calculation. Under this stipulation, the petitioner would have realized one dollar a pound of profit after any passing on of savings and after all costs and disbursements of every sort.

Coming now to the Second Circuit's point (4) concerning lack of proof of "temporary circumstances which depressed business during the base period": Relief under Section 722 (b) (4) of the Internal Revenue Code did not rest upon proof of a temporary depression during the base period. The Tax Court itself attributed that test to Section 722 (b) (2), a claim which petitioner had abandoned, when the Tax Court said:

> "With respect to petitioner's claim under the factors contained in paragraphs (1) through (3) and paragraph (5) of section 722 (b), * * *
>
> "Such evidence does not prove that there were * * * any temporary circumstances unusual in the case of the petitioner which depressed its business as required by paragraph (2) of that section * * *." (19 T.C. 535, at page 547.)

Section 722 (b) (4) relief rested upon a change in product or a change in method of selling, coupled with the application of the two-year push-back rule.

There is nothing in the opinion of the Second Circuit to indicate that that Court was aware of the two-year push-back rule.

The qualifications and procedure for relief under subsection (b) (4) of Section 722 are separate and distinct from the qualifications and procedure for relief under the other subsections of Section 722 (b). The respondent in his Bulletin has discussed this and has pointed out the differences with great clarity. The applicable parts of respondent's Bulletin are set out in the Appendix hereto at pages 25a *et seq.*

It is well settled that a taxpayer has to qualify under only one subsection of Section 722 (b). If it qualifies under one subsection, it cannot be required to qualify under any alternative one, nor will it be allowed to qualify under alternative subsections: *Rand Beverage Co.*, 13 T.C. 275, at page 287; *Fishbeck Awning Co.*, 19 T.C. 773, at page 781; *Hemenway-Johnson Furniture Co.*, 22 T.C. 43, at page 56.

The petitioner strongly urges that the three reasons advanced by the Second Circuit as alternate grounds for sustaining the Tax Court had no application to the issues before the Second Circuit, and petitioner feels that the Second Circuit should have reversed the Tax Court on the basis of the mistake of fact, the real issue before the Second Circuit.

There remains one important feature of this case which may have misled the Second Circuit. In the present case when the Tax Court heard proof establishing that there was a mutual mistake of fact in the prior case, the Tax Court attempted to belittle the mistake in order to sustain its prior decision. In so doing, it referred to the proof as "but a bit of evidence," and refused to disturb its prior conclusion of "not proved."

In that connection, there appears to have grown up in the minds of the respondent and the Tax Court a theory in regard to tax cases that a decision stating that a case was "not proved" is a far more damning conclusion than a decision that a case was disproved. Even if this be a sound theory, petitioner urges that it has no application in collateral estoppel cases.

There is a tendency to consider "not proved" as a sort of irrefutable ultimate fact completely disassociated from the items of evidence upon which it was based.

As a result, the theory seems to be that no mutual mistake or error that contributed to or that created the ultimate fact of "not proved" can be shown so as to disturb the ultimate fact based upon it.

The theory seems to be that the ultimate fact stands even after the "facts" on which it was based are refuted.

Under that theory, a material mutual mistake of fact upon which the prior case turned becomes but a "bit of evidence," in the eyes of the administrative agency that found the ultimate fact of "not proved."

The petitioner here claimed a change in business in two respects. One was a change in product from silk to nylon; the other was a change in method of distribution, from selling silk to jobbers to selling nylon to manufacturers.

The Tax Court here ruled out the change from manufacturing silk sheers to manufacturing sturdy nylons, stating that that was not a sufficient change to qualify under Section 722 (b) (4).

The Tax Court here admitted that a change in selling methods was a recognized change which would qualify

under Section 722 (b) (4); but through a mutual mistake of fact in the prior case a doubt was cast on the fact as to whether or not there was a change in selling methods. This doubt was removed by correcting the mistake.

Unfortunately, in the prior case, the Tax Court did not know of the mutual mistake of fact and, because of the confusion caused by the mutual mistake in the stipulation reached a decision of "not proved."

The ultimate fact of "not proved," according to the Tax Court, must stand in spite of disposing of the very "fact" on which it rests.

It is submitted that such a position is unsound and leads to gross injustice if applied to collateral estoppel cases.

CONCLUSION

The petitioner respectfully prays that the writ of certiorari be granted for the reasons above given.

Respectfully submitted,

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